German Banking Industry Committee | Die Deutsche Kreditwirtschaft

TRUE SALE INTERNATIONAL

Comments

on FSB consultation: Evaluation on Effects of G20 Reforms on Securitisation

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

True Sale International GmbH (TSI) is dedicated to support the development of the securitisation market in Germany and Europe, its regulation and the further development of its legal framework. Through training courses and specialist conferences, we contribute to the qualification of the participants and to an open exchange between market participants, supervisory authorities and science. In doing so, we do not narrowly define the securitisation issue and include related fields from the broad field of structured finance and asset-based finance.

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General comments

The consultation by the Financial Stability Board (FSB) "on the effects of G20 financial regulatory reforms on securitisation" is the start of a global discussion on the review of the securitisation framework. True Sale International GmbH (TSI) and the German Banking Industry Committee expressly welcome this initiative by the FSB. We believe it has become an urgent matter, both in terms of the timing and the content, to holistically assess the steps taken to regulate securitisation since the financial crisis. We believe that it is now the right time for the FSB to assess the contribution of regulation on financial stability as well as examine its impact on market participants and the consequences for the securitisation market as a whole. We are convinced that securitisation makes a positive contribution to financial market stability and that a level playing field in terms of regulation will strengthen their contribution to financing the transformation. We share in the below comments on the European experience and observations. These might be useful when we cross reading to other jurisdictions or derive conclusions for global initiatives.

Suitability of the securitisation framework for increasing financial stability

Following the financial crisis, the European securitisation market dropped sharply and has not recovered since. Between 2008 and 2013 the volume of securitisations issued fell by more than 70%. Since 2017, the volume of securitisations issued fluctuated between 200 and 250 billion euros per annum (Fig. 1).

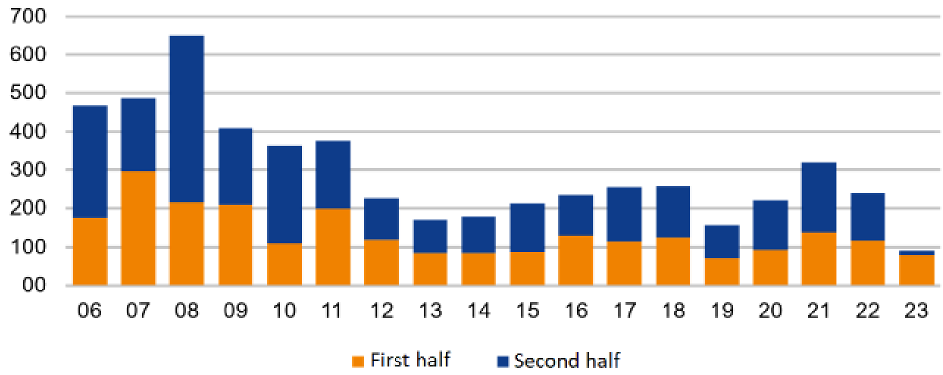

Figure 1: DZ-Bank

An assessment of the suitability of the securitisation framework for increasing financial stability is difficult given the figures we have available.

Since the financial crisis, the market has not been able to gain any overall momentum and return to pre-crisis levels, despite a series of comprehensive prudential reforms whose main aim is to rebuild trust. The consequence of which is that the importance of securitisations as a

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funding instrument has fallen sharply compared to other instruments. The European Systemic Risk Board (ESRB) was also unable to identify any significant systemic risks from securitisations.[1] Given this development, the key question in Europe is not to what degree have the reforms contributed to financial stability, but why has the securitisation market not developed or recovered in Europe. There is no simple answer to this question. The reasons for this stagnation of the European securitisation markets are manifold. It is highly likely that regulatory requirements such as capital requirements and disclosure obligations play a decisive role here as they are deemed overly conservative. A more proportionate regulation is required.

That securitisation can be a recognised instrument for capital market participants to participate in the financing of the economy, is not contested. In particular, the challenges of our time in creating a sustainable and digital economy will require major investment. Estimates suggest that Europe will need to invest around 620 billion euros per annum. At this scale, investments in Europe cannot be financed by the banks alone. Capital market participation is essential. And securitisation acts as a bridge to the capital market.

Against this background, we are calling for the FSB's evaluation to be expanded. Its focus should not only be on the suitability of regulation for increasing financial stability, but also on highlighting the positive contribution of securitisation. It also requires a general examination of how level the playing field is for the implementation of securitisation requirements in order to promote its contribution to financing the real economy. In addition, supervisory requirements, which go beyond the aim of increasing financial stability and ultimately create an additional burden for all participants, must be amended. In order to be ready to finance the transformation, the securitisation framework needs to be amended soon so that it is able to meet future requirements.

The German and European securitisation markets and their challenges

The European regulatory framework

After the financial crisis, a comprehensive and, in part, cross-sectoral regulatory framework was developed for securitisation in Europe. Anchor point was the Securitisation Regulation from 2017.[2] Insights gained from the financial crisis as a result of the regulatory assessment of securitisation were then incorporated in the regulation. The Securitisation Regulation again upheld a general ban on re-securitisation and a five percent risk retention across all tranches. It also reduced the dependence on external credit ratings and introduced more extensive due diligence and transparency requirements. Furthermore, it introduced a 'gold standard' for securitisations. If certain criteria for simple, transparent and standardised securitisations (STS) are met, these securitisations enjoy a privileged minimum risk weighting of 10 percent compared to non-STS securitisations with 15 percent. It should be noted that CRR introduced an overall increase in risk weighting. However, this was not enough to achieve the aim of

[1] ESRB - Monitoring systemic risks in the EU securitisation market - July 2022 [Monitoring systemic risks in the EU securitisation market (europa.eu)]

[2] [EUR-Lex - 02017R2402-20210409 - EN - EUR-Lex (europa.eu)]

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reviving the European securitisation market, as can be seen from the figures shown above. The recent extension of the scope of applicability of STS criteria to include synthetic securitisations[3] has certainly contributed to a considerable increase in synthetic balance sheet securitisations.[4] However, the scope for making funds available to the economy is by no means exhausted.

Based on the Securitisation Regulation, the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) have published a whole series of regulatory technical standards and guidelines which concretise the requirements contained in the Securitisation Regulation.[5] Particularly for the implementation of wide-ranging reporting requirements, the ESMA now has templates that are too complex.

In our opinion, securitisation reforms have certainly contributed to a reduction in systemic risk in Europe, but they have also severely restricted the development of the EU securitisation market.

Market developments

No matter the source, whether public (ESRB, EBA, ESMA, Commission) or private (European Benchmark Exercise[6]), the data are unequivocal. The EU securitisation market is small compared to the credit volume and the STS label has not changed anything, with a disappointing lack of securitisation growth. The ESRB report points out that "Over the past ten years the EU securitisation market has shrunk by around 40% (from €1.2 trillion in 2012). This is also reflected in the size of new issuances before and after the GFC, which were as high as €819 billion in 2008 compared with €181 billion in 2013. Compared with the total assets of the EU banking system, which is the main source of origination for EU securitisations, the size of the EU securitisation market is small at around 2% in the second quarter of 2021."[7]

In contrast, the US securitisation market benefits both from public guarantees and an implementation of reforms such as the BCBS framework tailored to the US market. The RMBS market benefits from the US government agencies guarantee. However, it is not the only explanation as the US market remains three times bigger than the EU market when RMBS guaranteed by US government agencies are excluded.

While in the US, the RMBS market is supported by government guarantees, residential real estate in Europe is refinanced, in particular, by issuing covered bonds. The European Securitisation Regulation has reinforced this practice. In countries such as the Netherlands, France, Italy and Portugal, there is a greater use of covered bond licences applied for after the financial crisis, resulting in market figures for RMBS steadily falling. Covered bonds are

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[3] EUR-Lex - 32021R0558 - EN - EUR-Lex (europa.eu)

[4] A new high for significant risk transfer securitisations (europa.eu)

[5] Overview of the Securitisation Regulation:
True Sale International: Verbriefungsregulierung / STS (true-sale-international.de)

[6] European Benchmarking Exercise, a market-led initiative organised by AFME, EDW and TSI, 50% of participating banks are of the German Banking Industry Committee (GBIC), current report: EBE_2022-H2_Report_2022-09-13_final.pdf (true-sale-international.de)

[7] See footnote 1.

afforded a low risk weight in European supervisory law and are, therefore, a very favourable alternative to securitisation.

It is important to emphasise the low default rates of European securitisations. The average annual defaults (1976 to 2022) in Europe for special sectors amount to 0.3% for RMBS, 0.2% for ABS and 0.1% for CLOs. All together the defaults are significantly lower in Europe than in the US (average annual defaults in Europe 1.0% and US 4.1%).[8] This is due, among other things, to Europe being more vigilant about lending standards. Banks are interested in long-term customer loyalty and also keep some of the credit risks on their own books. As a consequence, no so-called sub-prime mortgages were granted. The rules were further tightened with publication of the “Guidelines on loan origination and monitoring”.[9]

However, senior tranches of European securitisation receive a very high risk weighting compared to assets with the same risk. Banks and insurance firms are important investors in securitisation. The requirements of the CRR and Solvency II provide for risk weights that no longer correspond to their actual risk. For the most part, insurers, in particular, do not invest in securitisation because investing in the underlying portfolios is more attractive for them.[10] The reason for this is the prudentially motivated use of volatility rates for securitisation portfolios, derived from data from the financial crisis, in the insurer’s capital models. It is therefore cheaper for insurance firms in Europe to acquire the underlying portfolio of a securitisation than to invest in the securitisation.

What should the review cover?

Recalibration of capital requirements

Risk weights for securitisations do not reflect the actual risk associated with securitisations. It is therefore necessary that the proportionality of the calibration be examined and adjusted to meet the actual risk profile of the securitisation. Important considerations in this regard are the p-factor and the risk weights themselves. All types of securitisations should be taken into account during this adjustment, that is both STS and non-STS securitisations. Non-STS

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[8] Source: S&P 2022. 2022 Global Annual Structured Finance Default and Rating Transition Study, S&P Global Ratings. Note also that there are structural explanations for this different default behaviour. E.g., European mortgages have a dual recourse (creditor and property) while US mortgages are optionally non-recourse (property only). And in Europe, very specific extra rules exist in every single country which change the risk characteristics of RMBS.

[9] Guidelines on loan origination and monitoring | European Banking Authority (europa.eu)

[10] We note that European insurers have disappeared from the market as investors. This trend is - at least in part - explained by the calibrations of the regulatory requirements, which are too high and remain insufficiently segmented and risk-adjusted. Solvency II should be improved by reducing the gaps between the shocks applied under stress-testing to mezzanine and senior STS tranches as well as the gaps between respective STS and non-STS tranches based on additional data and common methodology. The stress factors applied to senior STS and non-STS tranches should be realigned where justified with those for equally rated corporate and covered bonds, while the stress factors for senior securitisation tranches must be commensurate with their risk and in principle lesser than those applied to the respective underlying exposures on a stand-alone basis.

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portfolios are particularly relevant for the economic transition, as most larger, more specific financing options cannot meet some of the STS criteria (for example requirements regarding granularity and homogeneity). In the European context it is important to emphasise that incentivizing only STS transactions/disincentivizing non-STS ones would create an uneven playing field to the detriment of the EU by constraining the range of securitisation options available to market stakeholders.

Effect of the introduction of an output floor

The final Basel III requirements introduce an output floor, that is minimum requirements for risk weighted assets with the standard approach. This regulation was, it seems, introduced towards the end of the negotiations and without any impact assessment. The results of internal evaluations show that the output floor might have a prohibitive effect. Banks are expecting to see a significant increase in capital requirements based on their individual business models and portfolios. Reducing the p-factor within the scope of European implementation of final Basel III requirements in order to apply the output floor has only a mild effect on the increase in capital. In addition, a recent study has shown that the efficiency of securitisations as connected to reduced risk weights drops – in some cases by 90% – with the introduction of the output floor, even though the senior tranche in the example is practically risk-free (both the expected and unexpected loss were over hedged by a factor of 1.3).[11,12]

Level playing field across jurisdictions and products

The European securitisation framework is, when compared to some other jurisdictions, significantly stricter in terms of what is considered adequate capital requirements as well as the transparency/due diligence requirements. These differences will, without a doubt, have a considerable effect on the competitiveness of the region. For example, it must be noted that only a few countries (EU, UK, Canada) have adopted the 'optional' STS label. Some jurisdictions do not even apply the Basel III securitisation framework (e.g. the p-factor) at all. The difference is obvious, for example when carrying out due diligence. The amount of time

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[11] AFME/Risk Control Research Paper „Impact of the SA Output Floor on the European Securitisation Market", 10.11.2022, Link: https://www.afme.eu/Publications/Reports/Details/Research-Report-Impact-of-the-SA-Output-Floor-on-the-European-Securitisation-Market.

[12] Impact of the output floor to sponsors of ABCP programmes: In the context of ABCP programmes, companies sell their receivables to a so-called "conduit", which in turn issues short-term asset-backed securities (ABCP). Sponsors provide so-called "fully-supporting" liquidity facilities in such transactions, which cover all losses of the investors from the securitised portfolio that exceed the purchase price discount agreed with the seller of the receivables. ABCP provides corporates with a refinancing option that usually leads to more favourable credit conditions than an unsecured loan.

The capital requirements of liquidity facilities are often determined using the so-called Internal Assessment Approach (IAA). However, with the introduction of the output floor, banks using the IAA will have to hold at least 72.5% of the capital requirements of the Standardised Approach to Securitisation (SEC-SA). However, in the SEC-SA, liquidity facilities will receive significantly higher capital requirements than in the IAA due to the non-senior status of the sponsor. This will result in significantly higher capital requirements, up to an increase of 100% for trade receivables securitisations.

We therefore expressly welcome the fact that in the implementation of Basel III in the EU, the so-called p-factors in the SEC-SA are to be halved for the purposes of applying the output floor. This will at least reduce the increase in capital requirements caused by the output floor. However, the relief described should not - as currently planned - expire in 2032, but be granted permanently. Furthermore, the halving of the p-factors should for reasons of a level playing field also be granted to banks that directly apply the SEC-SA."

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required for due diligence for senior AAA securitisation tranches is estimated to take 2 days in practice. Due diligence for high-yield bonds, on the other hand, takes an average of 2 hours.

However, competitiveness must also be considered with regard to adequate capitalisation of securitisations based on the risks as compared to risks similar to those for financial assets. Varying regulatory requirements are not appropriate from a risk perspective. And of course, unilateral regulatory requirements specifying transparency cannot be allowed to prevent investments in third-party securitisations.

Due diligence and transparency requirements, significant risk transfer assessment process

European investors and sponsors must comply with due diligence requirements under Article 7 of the Securitisation Regulation. We see little benefit in rigid templates, especially for private transactions. Preparation of said templates is associated with high costs both for the real economy and for the banks. This information does not provide any added-value to either investors or supervisors. The EU Commission also believes that templates have only a limited use in terms of meeting transparency regulation requirements and has called on the ESMA to revise them. The goal is to increase flexibility, especially for private transactions (moving away from rigid templates).

The due diligence requirement from Article 5(1)(e) of the Securitisation Regulation states that "the originator, sponsor or SSPE has, where applicable, made available the information required by Article 7 in accordance with the frequency and modalities provided for in that Article". This should be clarified to allow an EU-regulated investor in third-country securitisations to determine whether it has received sufficient information to meet the requirements to carry out its due diligence obligation proportionate to the risk profile of the securitization exposure. A determination should be possible without having necessarily received the ESMA Templates.

It is important to note that the European Parliament has also identified that it may be necessary to revisit these requirements. In its September 2020 report on further development of the CMU, it asked for "a review of the disclosure and due diligence requirements for third-party securitisation, covered bonds, and simple, transparent and standardised (STS) securitisation".[13]

Liquidity Coverage Ratio (LCR)

For banks, eligibility of senior STS and non-STS tranches in the LCR ratio is currently too restrictive and should be reviewed. An adjustment of the eligibility rules for the HQLA of the LCR for both Asset Backed Securities (ABS) and Asset-backed commercial paper (ABCP) should be envisaged to further support the EU securitisation market.

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[13] REPORT on further development of the Capital Markets Union (CMU): improving access to capital market finance, in particular by SMEs, and further enabling retail investor participation | A9-0155/2020 | European Parliament (europa.eu)

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Conclusion

From the point of view of the originator, transactions remain excessively burdensome and costly given the very conservative prudential charges. From an investor perspective, the prudential treatment of securitised assets is a major obstacle.

We believe the FSB must promote further work at the Basel Committee as a matter of urgency, and that this work should be clearly included in its 2023-2024 road map and beyond. Europe, the US and the UK are taking divergent approaches to modifying their securitisation frameworks. BCBS enhanced common rules would be very helpful to prevent fragmentation and an uneven playing field.

The risk-based reduction of capital requirements together with the reduction of implementation costs for the templates could significantly increase the attractiveness of securitisation as a means of financing the real economy and the transition to a sustainable economy. In order to finance the historical transformation of the real economy to encompass new digital and sustainable realities, we must reform the securitisation framework and apply that reform to all jurisdictions.

We welcome the FSB's desire to conduct further research and to include a broader range of stakeholders in the process. For our part, we will be happy to share any new insights from our analyses as the work on the securitisation framework review continues.

We would like to point out that the comments are still subject to approval by the bodies of the Association of German Public Banks.